UNITED STATES DEPARTMENT OF AGRICULTURE
FARM CREDIT ADMINISTRATION
WASHINGTON, D. C.

SUMMARY OF CASES

RELATING TO

FARMERS' COOPERATIVE ASSOCIATIONS

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FARMERS REQUIRED TO INCLUDE PATRONAGE REFUNDS OR DIVIDENDS IN THEIR INCOME TAX RETURNS

On April 13, 1950, the Bureau of Internal Revenue issued a ruling which reaffirmed the previous position of the Bureau requiring patrons of a farmers' cooperative marketing or purchasing association to account in their income tax returns for patronage refunds or dividends which they may have received from their cooperative regardless of how such refunds or dividends are paid. A complete copy of this ruling follows:

"BUREAU OF INTERNAL REVENUE
Income Tax Unit
Washington 25, D. C.

April 13, 1950

INCOME TAX INFORMATION RELEASE NO. 2

Patronage Dividends

"The earnings (savings) of farmers' cooperative marketing and purchasing associations, distributable to their patrons on the basis of the amount or value of produce furnished by them to the cooperatives or the value of supplies and equipment purchased by them from the cooperatives, generally are distributed to the patrons as patronage dividends in the form of cash or in one or more of the following forms:

Capital stock of the cooperative
Revolving fund certificates
Retain certificates
Certificates of indebtedness
Letters of advise as to net amount retained

"For Federal income tax purposes, the amounts which are includable in the gross income of the patrons to whom such distributions are made are not restricted to amounts distributed in cash. Distributions by cooperatives in the form of capital stock, or in any form other than cash, should be included in the gross income of the patrons to the same extent that such distributions would be included if paid in cash. This rule is applicable to patrons who file their Federal income tax returns on the basis of cash receipts and disbursements as well as those who file their returns on the accrual basis.

E. I. McLARNEY,
Deputy Commissioner,
Income Tax Unit."

Special Distribution.

Although the above ruling refers specifically to five methods by which an association may make a distribution in addition to a distribution by cash, it is believed that these five methods are not exclusive and that they should simply be regarded as representative of the ways by which a cooperative marketing or purchasing association may make distributions in ways other than by cash. In this connection, attention is called to the language in the foregoing statement reading: "Distributions by cooperatives in the form of capital stock, or in any form other than cash, should be included in the gross income of the patrons to the same extent that such distributions would be included if paid in cash." (Underscoring added.) The phrase "or in any form other than cash" is all inclusive.

In the case of a purchasing association, such as one engaged in the handling of fertilizer, it is assumed that there would be no objection to a patron's reducing the cost of the fertilizer purchased by him by the amount of the patronage refunds or dividends which he might receive on account of such purchases. In other words, in claiming the cost of the fertilizer as an expense of farming, he could simply reduce the cost of the fertilizer by the amount of the patronage refunds or dividends which he may have received. If a farmer claimed as a deduction the original cost of the fertilizer purchased by him as an expense of farming, he would then of course have to include as income the patronage refunds or dividends which he may have received on account thereof.

Patronage refunds or dividends from a marketing cooperative simply represent additional returns from commodities marketed.

In view of the fact that the foregoing ruling states that "This rule is applicable to patrons who file their Federal income tax returns on the basis of cash receipts and disbursements as well as those who file their returns on the accrual basis," it is clear that a patron of a cooperative marketing or purchasing association of farmers is required to include in his income tax return in the year of receipt all distributions made to him by his cooperative regardless of whether he is on a cash or an accrual basis.

The ruling of the Bureau set forth above should be considered in connection with rulings previously made on the same subject by the Bureau of Internal Revenue or the Treasury Department; see Summary No. 45, page 20.

In Baiocchi v. Ewing, 87 F. Supp. 520, it appeared that the plaintiff was a widow of a former employee of the California Prune and Apricot Growers Association. Upon the death of the employee, his widow applied for "survivors' insurance benefits under the Social Security Act of August 14, 1935, and amendments, 42 U.S.C.A. §§ 401-409." The widow's claim for survivors' insurance benefits was rejected by the Social Security Administration on the ground that the work in which her husband had been engaged was agricultural labor, and hence was not covered by the Social Security Act. Upon the rejection of her claim the widow brought suit.

The California Prune and Apricot Growers Association is a cooperative corporation acting as the marketing organization for 28 local nonprofit corporations. It is referred to in the opinion of the Court as the Central Sales Agency. The following quotations show the basis for the holding that the plaintiff was entitled to survivors' insurance benefits:

> "When Locals turn dried fruit over to the Central Sales Agency the fruit is in a merchantable state. Title to the fruit passes to the Central Sales Agency upon delivery from the Locals, which acquire it from the individual members of the corporations. Payment of the purchase price is postponed, but it is fixed and the Central Sales Agency is subject to account to the Locals according to contract, by-laws and statute. Fruit sometimes remains in storage at the Central Sales Agency for as long as eighteen months. It is sold under its own brands and also under private brands owned by its customers. <u>When dried fruit leaves the packing plant it is in the same condition as when it is sold to the housewife. About 40% of the carton pack is sold to chain stores; about 75% of the bulk is sold to chain stores and super markets.</u>"

> "Specifically, the functions performed by the decedent for the Central Sales Agency were: (1) receiving and grading; (2) processing and packing; (3) shipping; (4) maintenance.

> "The Central Sales Agency for more than twelve years has made payments of taxes and collected contributions from employees in accordance with the provisions of the Social Security Act. It has acted voluntarily to protect its employees, convinced that their work falls within the coverage of the Act. The instant case is not brought at the behest of the cooperative but is necessitated by the interpretation placed upon social security coverage by the Administration.

> "The specific question for decision is whether plaintiff's deceased husband was an employee of an organization included within the terms of the Social Security Act.

"The pertinent part of the Social Security Act whose coverage is in dispute defines agricultural labor as follows: 'The term "agricultural labor" includes all services performed * * * (4) in handling, planting, drying, packing, packaging, processing, freezing, grading, storing, or delivering to storage or to market or to a carrier for transportation to market, any agricultural or horticultural commodity; but only as such service is performed as an incident to ordinary farming operations or, in the case of fruits and vegetables, as an incident to the preparation of such fruits or vegetables for market. The provisions of this paragraph shall not be deemed to be applicable with respect to service performed in connection with commercial canning or commercial freezing or in connection with any agricultural or horticultural commodity after its delivery to a terminal market for distribution for consumption.' 42 U.S.C.A. § 409(1).

"Did the decedent, whose work in the packing house in San Jose consisted of receiving, grading, processing and packing dried fruit for purposes of preparing it for sale to chain stores, cooperatives, and super markets, and doing maintenance work, constitute agricultural labor within the above definition of the Social Security Act?

"From the undisputed statement of facts, it is clear decedent worked for a terminal market for distribution for consumption after the dried fruit had reached the grocer's or terminal market.

"In construing legislation, such as the Social Security Act, it is axiomatic that the Court should be liberal in its interpretation. Grace v. Magruder, 80 U.S. App. 53, 148 F. 2d 679; Latimer v. U. S., D. C., 52 F. Supp. 228; Berger v. Social Security Board, D. C., 66 F. Supp. 619. Furthermore, this Court is free to make its own determination of the scope of the Statute. Social Security Board v. Nierotko, 327 U.S. 358, 66 S. Ct. 637, 90 L. Ed. 718, 162 A.L.R. 1445.

"The task of analyzing and construing the sections of the Social Security Act, whose meaning gives rise to the present controversy, has been simplified by two recent rulings by the Court of Appeals for the Ninth Circuit. In cases which closely parallel the instant suit, the Appellate Court has held that work performed in employment identical with that of decedent in a processing and packaging plant is 'covered' employment within the meaning of the Social Security Act. This is the holding in Miller v. Burger, 161 F. 2d 992, and Miller v. Bettencourt, 161 F. 2d 995. In the Bettencourt case the Court held that the plant in which Bettencourt worked was a 'terminal market' for the farmer producers who sold and delivered their dried fruit to that concern. As the Court stated, 161 F. 2d at page 994: 'Facts make abundantly clear that it was only after the farmer producer sold and delivered

the fruit to Rosenberg Bros., that Burger's services * * * were performed for that commercial concern. In this state of the record we regard his services as being performed after all "agricultural labor" in connection with such dried fruit had ceased'. Accordingly, the Court found that the plaintiff was entitled to coverage under the Social Security Act, affirming Judge Mathes and referring to his opinion in Burger v. Social Security Board, supra.

"The only basis urged for distinguishing the case at bar from the Burger and Bettencourt cases is the cooperative status of the Central Sales Agency for whom plaintiff's deceased husband worked. This distinction is not sound. In North Whittier Heights Citrus Association v. National Labor Relations Board, 109 F. 2d 76, the Court of Appeals for the Ninth Circuit held that a cooperative similar to that for which decedent worked was not one engaged in agriculture to such an extent that its employees would be considered 'agricultural laborers' within the exemptions of the National Labor Relations Act, 29 U.S.C.A. § 151 et seq. The reasoning in the North Whittier case applies with equal force herein.

"The Social Security Act makes no distinction between cooperatives and other forms of corporations in defining its coverage. While defendant has explored the possibility of making out a technical case in favor of its position, viz. that employees of the Central Sales Agency are indirectly employees of the individual farmer members who belong to the local cooperatives, this Court is not prepared to base its decision on strained legal niceties. Even on the distinguishing features which defendant seeks to emphasize between the Central Sales Agency and a profit corporation, there is authority for holding that the attributes of the two types of corporations are similar for many legal purposes, including coverage under social security legislation. See California Employment Commission v. Butte County Rice Growers Association, 25 Cal. 2d 624, 154 P. 2d 892.

"The basic reason for excluding agricultural laborers from coverage of the Act is to be found in the solicitude of Congress for the small farmer who is ill-equipped to maintain complex records on laborers who are hired on a strictly seasonal basis. Obviously the Central Sales Agency, which employs as many as 1500 workers and has a complete accounting staff is not in the category of the individual farmer who requires freedom from bookkeeping responsibilities." (Underscoring added.)

From the foregoing quotations, it is clear that the principal contention of the Social Security Administration was that the California Prune and Apricot Growers Association was not a terminal market within the meaning of the Social Security Act. As pointed out in the opinion, in previous holdings by the Circuit Court of Appeals for the Ninth Circuit, it had

been held that employees of noncooperative corporations that were engaged in activities like those performed by the former husband of the plaintiff were not engaged in agricultural labor, and that such noncooperative corporations were terminal markets. In view of the fact that "About 40% of the carton pack is sold to chain stores; about 75% of the bulk is sold to chain stores and super markets," it would appear that if the California Prune and Apricot Growers Association was not a terminal market, there would be no terminal market between the farm and the retail stores in which the dried fruit was sold at retail.

A point that was not stressed in the opinion is the fact that the California Prune and Apricot Growers Association is a marketing association consisting of 28 local nonprofit corporations. In other words, the fruit in question was first received by the 28 local nonprofit corporations, and then was passed on to the Central Sales Agency. However, it is not believed this fact is of controlling importance. In other words, if the California Prune and Apricot Growers Association had received the fruit direct from the farmers who grew it and had then performed the same identical functions that were performed by it when the fruit was received from the 28 local corporations, it is believed the result would have been identical. Apparently, the Court was of this opinion because it laid no stress upon the fact that the fruit was received by the Central Sales Agency from local corporations.

Whether title has passed from the farmer does not seem of controlling importance in determining if a market is a terminal market.

If an employer, whether a cooperative corporation or otherwise, is in fact a terminal market, then the fact that it has some employees who are engaged in labor that would be classified as agricultural labor, if the employer was not a terminal market prevents such labor from being classified as agricultural labor. This would seem to follow from the last sentence in the paragraph of the statute under consideration. This last sentence appears to control everything that precedes it. The sentence reads as follows:

> "The provisions of this paragraph shall not be deemed to be applicable with respect to service performed in connection with commercial canning or commercial freezing or in connnection with any agricultural or horticultural commodity after its delivery to a terminal market for distribution for consumption."

In the case of United States v. Colfax Grain Growers, Inc., 157 F. 2d 633, Summary No. 32, p. 18, "The question presented by this appeal is whether a farmers' cooperative association is required to pay social security taxes on its employees who perform services in connection with the warehousing, handling, grading and storage of agricultural commodities produced by both members and non-members of the cooperative when more than half the services rendered are performed on products of members of the cooperative association." (Underscoring added.) It was held that the employees of the cooperative association were engaged in the performance of agricultural labor, and hence that no Social Security taxes were required to be paid on account of their labor. The point apparently was

not raised whether the cooperative association was a terminal market, and it is doubted if in fact it was a terminal market.

In the case of Gold Knob Outdoor Advertising Co. v. Outdoor Advertising Ass'n of Texas, Inc., decided by the Court of Civil Appeals of Texas, 225 S.W. 2d 645, it appeared that the plaintiff brought a suit against Outdoor Advertising Association of Texas, Inc., to compel that association to admit it to membership. "Appellant alleged that it had met all the requirements set out in the constitution and by-laws of appellee and was entitled to be admitted to membership in its organization; that appellant 'notified appellee of its desire to become a member thereof and requested appellee to forward to appellant application forms required to be completed by appellant as a condition to becoming an active member of the appellee.' Pursuant to such request, and on or about the 9th day of January 1942, appellant received two application forms. Appellant was unable to complete and file the application for the reason that it could not secure the signatures of two active members of appellee endorsing its application as required by the application blank. No such requirement of endorsement is contained in the constitution and by-laws of appellee." (Underscoring added.)

As shown by the foregoing quotation, it was the position of the plaintiff that it qualified under the constitution and bylaws of the defendant for membership therein. It contended that inasmuch as the constitution and bylaws of the defendant did not require that two members of the defendant endorse the application of an applicant for membership, it was unnecessary for it to obtain such endorsements.

In holding that the Trial Court was correct in refusing to require the defendant corporation to admit the plaintiff to membership, the Appellate Court said in part:

> "Appellee had the right to accept appellant to membership in its organization, or to refuse to accept it as a member. Most, if not all, of the authorities cited by appellee have to do with the legal rights and liabilities of members of an organization, and it is quite generally held by the courts in the various states that a member of an organization has recourse to the courts when the organization invades his rights. A different rule applies to a nonmember. In 4 Am. Jur., 462, Sec. 11, it is said: 'Membership in a voluntary association is a privilege which may be accorded or withheld and not a right which can be gained independently and then enforced. The courts cannot compel the admission of an individual into such an association, and if his application is refused he is entirely without legal remedy, no matter how arbitrary or unjust may be his exclusion.'
>
> "And this is true whether the association is incorporated or unincorporated. Chapman v. American Legion, 244 Ala. 553, 14 So. 2d 225, 147 A.L.R. 585. 'As a general rule, admission to membership in a voluntary association is a matter within the complete and exclusive jurisdiction of the association.' 7 C.J.S., Associations § 23, page 56." (Underscoring added.)

It is believed the foregoing principles are in general applicable to cooperative associations, whether incorporated or unincorporated, and in the absence of a statute requiring a cooperative association to admit persons to membership upon their meeting certain conditions, it is believed that fundamentally and generally speaking no person may compel a cooperative association to admit him to membership. See, in this connection, "Legal Phases of Cooperative Associations," page 65. For a case that suggests that under certain conditions a cooperative association might possibly be compelled to admit persons to membership, see Associated Press, et al., v. United States, 89 L. Ed. 1512, Summary No. 27, p. 3.

In the case of Hill, et al., v. Partridge Cooperative Equity Exchange, et al., decided by the Supreme Court of Kansas, 214 P. 2d 316, the question for decision was whether minority stockholders of a corporation could be compelled to take less than the book value of their stock when the corporation was reorganized under the Cooperative Marketing Act of Kansas, in pursuance of a specific provision in the statute of that State providing that corporations heretofore organized may adopt and come under the provisions of the Cooperative Marketing Act.

It appeared that in 1915 the Partridge Cooperative Equity Exchange was incorporated as a corporation, organized for profit, and that it had an authorized capital stock of $20,000, divided into 800 shares of a par value of $25 each. At the time of the reorganization, the capital stock was owned by approximately 115 shareholders. Five percent dividends had been paid on the stock for several years, and the book value of each share of common stock was more than $62.50 a share.

The Cooperative Marketing Act of Kansas was enacted in 1921. It provided, in General Statutes of Kansas of 1935, Chap. 17, Art. 1621, that corporations heretofore organized might be brought under the provisions of that Act. The Article in question reads as follows:

> "Adoption of act by existing corporations. Any corporation or association organized under previously existing statutes may by a two-thirds vote of its stockholders or members be brought under the provisions of this act by limiting its membership and adopting the other restrictions as provided herein. It shall make out in duplicate a statement signed and sworn to by its directors, upon forms supplied by the secretary of state, to the effect that the corporation or association has by a two-thirds vote of its stockholders or members decided to accept the benefits and be bound by the provisions of this act. Articles of incorporation shall be filed as required in section 8 (17-1608), except that they shall be signed by the members of the board of directors. The filing fee shall be the same as for filing an amendment to articles of incorporation. [L. 1921, ch. 148, §21; May 25; R. S. 1923, §17-1621.]"

The Partridge Cooperative Equity Exchange had conformed to the statutory requirements stated above, and amended articles of incorporation were filed on March 1, 1946, thereby converting the corporation into a cooperative within the meaning of the Cooperative Marketing Act.

The plan of reorganization adopted by the stockholders of the corporation was that each shareholder in the old corporation who was eligible to be a shareholder in the cooperative association would receive one share of common stock of a par value of $25, and in addition $3.75 in certificates of indebtedness. For all additional common stock held by a shareholder in the old corporation who was eligible to be a stockholder in the cooperative, he would also be entitled to receive certificates of indebtedness of a face value of $28.75 each. If a member of the old corporation was not "a bona fide producer of agricultural products handled by the

association," he was entitled to receive a certificate of indebtedness for $28.75 for each share of common stock owned by him.

Minority stockholders of the old corporation filed a suit to prevent the reorganization plan from going into effect. Their principal contention was that they were not receiving adequate compensation for their equities in the old corporation. The Trial Court found that the book value of each share of stock in the old corporation was $63.80. "It finally concluded that the defendants should be enjoined from re-issuing the stock of its shareholders upon the basis proposed unless the corporation agreed to fix the value thereof at the amount above stated." (Underscoring added.) The defendants then appealed the case to the Supreme Court of Kansas, which affirmed the judgment of the Trial Court. In affirming the judgment of the Trial Court, the Supreme Court of Kansas pointed out that the corporation was originally "organized as one for profit."

Attention is called to the fact that the Trial Court found, and the Supreme Court of Kansas accepted the finding, that the general plan of reorganizing the old corporation was not in and of itself an inequitable method of converting the old corporation into a cooperative one. Apparently, the effect of the decision was to require the issuance to the minority stockholders of securities at least equal to the book value of the stock which they held in the old corporation. The case should be regarded as one that upholds the right of a corporation previously organized to bring itself under the provisions of the Cooperative Marketing Act of Kansas. In this connection, the Supreme Court of Kansas said:

> "There is no doubt that under the statutes to which reference has been made that upon a favorable two-thirds vote of its stockholders the original corporation had power to come under the cooperative marketing act, but that cannot be construed as a grant of power to the majority to do as they pleased with the property and property rights of the minority." (Underscoring added.)

The Cooperative Marketing Act of Kansas did not provide how the minority stockholders of a corporation that was being reorganized should be treated. "In this connection we note also that under G.S. 1935, 17-1621, which authorizes the changeover of a cooperative society to a cooperative marketing corporation, no express provisions are made pertaining to dissenting stockholders, but that under 17-1628, it is provided that the provisions of the general corporation laws shall apply except where such provisions are in conflict with or inconsistent with the provisions of the cooperative marketing act. Not because it is controlling, but merely for the analogy to be drawn, we direct attention to the provisions of the general corporation laws dealing with consolidation and merger of corporations, G.S. 1947 Supp. Ch. 17, Art. 37, and especially to 17-3707 making provision for determining the value of the shares of a dissenting stockholder who refuses to convert his stock, and for judgment for the amount fixed, as provided in that section. To say the least, it is a legislative declaration that the majority stockholders of a corporation may not with impunity do as they will with the rights of the minority and that the minority is without remedy."

The provision in the Cooperative Marketing Act of Kansas quoted above providing how a corporation previously organized may bring itself under the Cooperative Marketing Act of Kansas is a provision that is common to the Cooperative Marketing Acts of many of the States. In the case of Maclaren, as Receiver of Goodhue County Co-operative Company v. Wold, 168 Minn. 234, 210 N.W. 29, 55 A.L.R. 321, 172 Minn. 334, 215 N.W. 428, doubt was expressed by the Supreme Court of Minnesota as to the constitutionality of a comparable provision in the Cooperative Marketing Act of Minnesota.

In a North Dakota case, Mohall Farmers' Elevator Company v. Hall, 44 N.D. 430, 176 N.W. 131, 133, involving the general issue now under discussion, the Secretary of State refused to accept an amendment to the articles of incorporation of a corporation that was intended to bring the corporation in question under the Cooperative Marketing Act of North Dakota. A suit was therefore brought against the Secretary of State to compel him to accept the amended articles of incorporation, and the Supreme Court of North Dakota held "that the secretary of state cannot be heard to assert in this proceeding that the rights of nonconsenting stockholders have been or may be violated."

It is believed that the Kansas case discussed above is the first case that squarely upholds the statutory provision providing the machinery for converting a corporation previously organized into one that is subject to the Cooperative Marketing Act of a particular State. Of course, there is little likelihood of any question arising if all the members or stockholders of a corporation agree to the reorganization, and the Kansas case in effect simply holds that minority stockholders must be dealt with fairly.

Attention is called to the fact that in a cooperative association that is required to allocate on a patronage basis all reserves accumulated from year to year, this operates normally to prevent the book value of the stock from having a value in excess of its par value.

For a general discussion on the reorganization of associations, see page 79 of "Legal Phases of Cooperative Associations."

ARTICLES FOR "NONPROFIT" CORPORATION REFUSED BY SECRETARY OF STATE

In the case of State v. Sweeney, decided by the Supreme Court of Ohio, 91 N.E. 2d 13, the question for decision was whether the Secretary of State acted right in refusing to accept and record articles of incorporation that had been prepared for a proposed nonprofit corporation. As indicated, the Secretary of State refused to record such articles of incorporation, and the would-be incorporators of the corporation brought an original action in the Supreme Court of Ohio to obtain a writ of mandamus to require the Secretary of State to record the articles of incorporation. The statute of Ohio under which it was attempted to form the corporation reads as follows:

> "A corporation not for profit may be formed hereunder for any purpose or purposes not involving pecuniary gain or profit for which natural persons may lawfully associate themselves, provided that where the General Code makes special provision for the filing of articles of incorporation of designated classes of corporations not for profit, such corporation shall be formed under such provisions and not hereunder."

The following quotation from the opinion shows the purposes for which the corporation was organized and the reasons why the Court held that the proposed corporation could not be organized as a nonprofit corporation:

> "A study of the previously quoted purpose clause reveals that this corporation will be authorized 'to attain said purposes by acquiring the assets, liabilities and good will of the Greenhills Home Owners' Corporation * * * [a corporation for profit]; by purchasing all or any part of the property known as the "Greenhills Greenbelt" community * * *; by conveying, leasing, developing or operating such property as the aforesaid purposes, the civic interest of the Greenhills community, and principles of good land and village planning demand; by devoting any funds remaining after payment of the costs expended toward and in furtherance of the aforesaid purchase and development to a public charitable trust to be known as the Greenhills Civic Trust, for the benefit of the civic advancement and development of the general community in and about Greenhills, and the general social welfare of the citizens thereof; and by doing any or all other things in furtherance of said purpose to the same extent as natural persons might or could do.' Thus, the proposed nonprofit corporation will have authority to acquire the assets and liabilities of an existing corporation for profit to purchase realty, to convey realty, to lease realty, to develop realty, to operate realty; to devote surplus funds to a trust for the benefit of the citizens and the development of the community, and to do all things a natural person might or could do in furtherance of the objectives.

"Is this broad authority consistent with the concept of a corporation not dealing in real estate and not for profit? To so hold would require a disregard of the foregoing plain language. However, the relators point to the additional provision that each member of the corporation agrees not to accept pecuniary gain or profit from any corporate surplus. One difficulty with this contention is the clear purpose to confer both direct and indirect benefits to members of the corporation irrespective of the realization of a surplus. That these benefits include pecuniary gain or profit is demonstrated by the expressed purpose to secure the benefits of home ownership to persons of 'modest financial status.' (Italics supplied.) Obviously it is a most commendable objective to encourage and assist the purchase of homes by those who otherwise could not afford such an acquisition. But just as obviously this fact does not warrant a disregard of the statutory provision enacted by the General Assembly. As was said in the opinion in the case of State ex rel. Troy, Pros. Atty., v. Lumbermen's Clinic, 186 Wash. 384, 58 P. 2d 812, 816: 'Profit does not necessarily mean a direct return by way of dividends, interest, capital account, or salaries. A saving of expense which would otherwise necessarily be incurred is also a profit to the person benefited. If respondent renders to its incorporators or members, or to businesses in which they are interested and in whose profits they share, a service at a cost lower than that which would otherwise be paid for such service, then respondent's operations result in a profit to its members.'

"But in the instant case even any surplus placed in the trust fund may be used for the 'development of the general community' in which the relators live."

From the foregoing quotation, it is apparent that the Court proceeded upon the theory that the indirect benefits which the organizers of the corporation might derive therefrom prevented the corporation from being a nonprofit corporation. Apparently this conclusion was based wholly upon the fact that the organizers of the corporation might receive indirect peculiar benefits from its formation.

There was a comprehensive and convincing dissent. In the dissenting opinion reference was made to the case of Snyder v. Chamber of Commerce, 53 Ohio St. 1, 41 N.E. 33, in which opinion the Court said:

"'Corporations for profit, within the meaning of the statute, are those which are formed for the prosecution of business enterprises with a view to realizing gains, to be distributed as dividends among the shareholders in proportion to their contributions to the capital stock.'" (Underscoring added.)

It is believed that the principle stated in the foregoing quotation represents the general rule. It is submitted that the majority opinion is directly at variance with the decision of the Supreme Court of the United

States in the case of United States v. Pacific Coast Wholesalers' Association, 94 L. Ed. 330, Summary No. 45, page 1.

WHAT IS A MUTUAL INSURANCE ASSOCIATION?

The White River Burial Association, an unincorporated burial insurance association, paid income and capital stock taxes under protest, and then brought suit to recover the same. In White River Burial Association, et al., v. Thompson, 81 F. Supp. 18, the Court said:

> "Plaintiff, White River Burial Association, is entitled to judgment for Income Tax and Capital Stock Tax, penalties and interest erroneously collected in the sum of $13,357.97, plus interest thereon at 6% per annum from February 3, 1947."

The case was then appealed by the defendant and the judgment of the District Court was affirmed in Thompson v. White River Burial Association, et al., 178 F. 2d 954. On appeal, the claim for capital stock tax, penalty, and interest was abandoned.

The claim for income taxes against the burial association was based on the theory that the association was an insurance company other than a life or mutual insurance company, and hence was liable for income taxes under 26 U.S.C. 204. On appeal, the Court said:

> ". . . no contention is made that the taxpayer is liable for income tax if, as the trial court held, the taxpayer is a mutual insurance company other than life or marine."

In other words, it was apparently admitted that if the burial association was a mutual insurance company other than a life or marine insurance company, no income taxes were due.

In showing that the burial association was a mutual association, the Court said in part:

> "The argument is that taxpayer is not a mutual company, because an essential characteristic of a mutual insurance company is that it provide for the return to its policyholders of the excess in the premiums charged over the cost of insurance. Penn Mutual Co. v. Lederer, 252 U.S. 523, 533, 40 S. Ct. 397, 64 L. Ed. 698; American Ins. Co. of Texas v. Thomas, 5 Cir., 146 F. 2d 434, 436. Appellant contends that no distribution of surplus can be made by the taxpayer to its members until dissolution or liquidation, and that provision for the return of accumulated premiums upon dissolution or liquidation does not suffice to qualify taxpayer as a mutual.
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> * * * * * * * *
>
> "The bylaws of the taxpayer place the control of its operations and of the funds held by it completely within the power of its members, to be exercised at any annual meeting, at which every member has a vote and at which the majority rules. Nothing in the law governing the taxpayer prohibits the return to its

members of the excess of premiums over the cost of insurance if and when the members authorize return at any annual meeting. (Underscoring added.)

* * * * * * *

"It is not necessary to mutuality that periodic returns from premiums collected be made to the members of an association. It is enough that the power exists when a surplus of premium receipts over cost of insurance in fact exists; and the determination of the existence of the appropriate surplus is largely within the discretion of those charged with the management of the association. Order of Railway Employees v. Commissioner, 2 T.C. 607, 613-615. In the Railway Employees case the Tax Court pronounced unsound the contention made by the appellant here that taxpayer may not be taxed as a mutual because members who allow their memberships to lapse may never receive a return of any part of the premiums paid by them." (Underscoring added.)

Attention is called to the fact that the Court specifically held that the fact that the organization papers of the insurance association did not provide for the return to policyholders "of the excess of premiums over the cost of insurance" did not in and of itself prevent the association from being a mutual one, as the members had authority "at any annual meeting" to direct that such excess amounts be refunded at any time.

The fact that members of a mutual association who allow their memberships to lapse may not receive any part of the premiums paid by them was again held not to adversely affect the character of a mutual association.

No reason is apparent why the principles followed by the Court in holding that the burial association was a mutual insurance association would not be applicable in any instance in which the question arose of whether a given association of any type was in fact a mutual association. Of course, if an applicable statute defined specifically what was meant by the term "mutual association," the statutory definition would govern.

Paragraph 11 of section 101, 26 U.S.C., provides for the exemption from the payment of Federal income taxes of "Mutual insurance companies or associations other than life or marine (including interinsurers and reciprocal underwriters) if the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) does not exceed $75,000."

As shown by the foregoing quotation, the only mutual insurance companies that are exempt under the foregoing language are those that do not receive in excess of $75,000 "during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments)," and mutual insurance companies other than mutual, life, or marine insurance companies that are not within the scope of the exemption quoted above are liable for income taxes in accordance with the provisions of section 207 of 26 U.S.C. However, as shown by the case discussed above, the rules for determining the amount of income taxes to be paid by a mutual insurance company that

is liable therefor under the terms of section 207 of 26 U.S.C. are different from the rules for determining the liability of insurance companies other than life or mutual companies for income taxes under the provisions of section 204 of 26 U.S.C.

RURAL ELECTRIC COOPERATIVE BUYS POWER COMPANY

The White Mountain Power Company petitioned the Public Service Commission of the State of New Hampshire for authority to issue its note for $200,000, payable to the United States of America.

New Hampshire Electric Cooperative, Inc., and the White Mountain Power Company requested the Public Service Commission of New Hampshire to find that a power and service contract, to be entered into between the two companies, was reasonable.

New Hampshire Electric Cooperative, Inc., requested the Public Service Commission of New Hampshire for permission to construct service lines to serve properties within a thousand feet of lines of the White Mountain Power Company. All the petitions were heard jointly by the Public Service Commission. After the hearings were concluded, the Commission certified to the Supreme Court of New Hampshire for decision the following question:

> "'Does Revised Laws, Chapter 273, allow the New Hampshire Electric Cooperative, Inc., a rural electrification association, to own all of the securities of the White Mountain Power Company, an electric utility, and to operate that company, under the circumstances disclosed in the accompanying record?'" (Petition of White Mountain Power Company, 71 A. 2d 496)

The character of the White Mountain Power Company and the proposed relationship between that company and New Hampshire Electric Cooperative, Inc., is disclosed by the following quotation:

> "White Mountain Power Company is a public utility furnishing electricity to approximately 7800 consumers in central New Hampshire. It was incorporated as a business corporation in 1938. New Hampshire Electric Cooperative, Inc. was incorporated in 1939 under the provisions of Laws of 1939, c. 212, authorizing agricultural cooperatives 'to generate, transmit, and distribute electric energy and to conduct other services in connection therewith.' R.L. c. 273, §§52-56. It is presently serving approximately 5000 members by means of 1600 miles of lines, to some extent surrounding the lines of White Mountain Power Company. The depreciated value of its assets is $1,950,000, and it is indebted to the Rural Electrification Administration in the approximate sum of $2,421,000, payment of $121,000 of which is in default. Under the terms of its loan contract, the Administration has control of the company's operations during default.
>
> "The petitions before the Commission arise out of an undertaking on the part of the Cooperative to acquire from their present holder for a price of $1,350,000, all of the outstanding securities of the Power Company, which consist of its capital stock, $400,000 of first mortgage bonds, and $200,000

of debentures. Funds with which to make the purchase are to be derived from a loan of $2,712,000 granted by the Rural Electrification Administration, which is contingent upon acquisition of the securities by the Cooperative. The securities in turn are to be hypothecated as security for the loan. It is further proposed that $200,000 of the advance to the Cooperative shall be paid to the Power Company, as a contribution to be used for the retirement pro tanto of short term indebtedness of the latter. The balance of the loan to the Cooperative is to be used by it for construction of extensions from the Power Company system, and of other extensions from the Cooperative's own system, and for improvements to the latter system.

"In conjunction with the described transaction, the Power Company desires to borrow $200,000 of the Rural Electrification Administration to improve its existing system, and to finance certain extensions to which it is committed which will benefit 67 of its own customers. This borrowing is to be evidenced by the Company's 35 year note payable to United States of America, bearing interest at the rate of two per cent, and secured by mortgage of the franchise and all other assets of the Company. The petition of the Power Company accordingly seeks a finding by the Commission that issue of the proposed note will be 'consistent with the public good.'"

The statute under which the electric cooperative was incorporated on its face appeared to authorize the acquisition of all the securities of the power company. This is shown by the following quotation from the opinion:

"No claim is made on behalf of the State that acquisition of the Power Company securities by the Cooperative will be unlawful for want of approval of the transfer by the Public Service Commission. The jurisdiction of the Commission is restricted by statute to authorization of the acquisition of securities by a public utility. R.L.c. 289, § 31. By the provisions of R.L.c. 273, § 56, the Cooperative is 'exempt from the jurisdiction of the public service commission.' The certified question accordingly depends wholly upon the corporate authority granted the Cooperative by the chapter of the Revised Laws cited in the question.

"The particular provisions of Chapter 273 under which the Cooperative was organized confer upon an association incorporated thereunder the power, among others, to acquire transmit, distribute and sell electric energy to its members 'and to other persons not in excess of ten per cent of the number of its members.' R.L. c. 273, § 52, I. It authorizes such a cooperative to purchase, own and hold electric transmission and distribution lines, 'and any and all kinds and classes of real and personal property whatsoever, which shall be deemed necessary, convenient, or appropriate to accomplish the purpose for which

the Co-operative is organized.' Section 52, III. An electric cooperative is further authorized to have and exercise any and all other powers which may be necessary, convenient or appropriate to accomplish the same purpose. Section 52, VIII.

"By Section 53 of the chapter such cooperatives are also granted 'all of the powers and privileges of co-operatives organized under any other provisions of this chapter.' These powers are expressly set forth in section 3 of the chapter. Among them is the power 'to purchase or otherwise acquire, to exercise all rights of ownership or control in and to sell, transfer, or pledge * * shares of the capital stock or bonds of any corporation or association engaged in any related activity or in the * * * handling or marketing of any products handled by the association.' Section 3, VI. There is also granted the power 'to establish reserves and to invest the funds thereof in bonds or in such other property as may be provided in the by-laws', section 3, VII, and finally, 'any other rights, powers, and privileges granted by the laws of this state to corporations organized under the general laws of this state, except such as are inconsistent with the express provisions of this chapter * * *.' Section 3, XI. In connection with the latter provision it may be noted that a business corporation is authorized to hold shares, bonds and securities of other corporations, as the purposes of the corporation may require. R.L.c. 274, § 4, V. See note, 31 Col. Law Rev. 281, 284.

"In view of the powers thus conferred upon the Cooperative, there can be no doubt that the statute allows it to acquire and own the securities of the Power Company, and to exercise all rights of control which any owner of such corporate securities might lawfully exercise, unless the power to do so is elsewhere expressly withheld, or is inconsistent with other express provisions of the act." (Underscoring added.)

It was argued, however, by the State that certain provisions in the statute under which the electric cooperative was organized operated to restrict the right of the electric cooperative to acquire the securities of the power company. In this connection, it was urged that no person might become a member of the cooperative unless he agreed to use electricity furnished by the cooperative, and that a person ceased to be a member if he refused to take service from the electric cooperative. It was also pointed out that only persons residing on premises not receiving central station service on June 16, 1939, were entitled to receive service from the cooperative, except as the Public Service Commission might find that it is in the public interest for it to do so. Attention was also called to a further provision in the statute "that the persons entitled to be admitted to membership are those who are 'not receiving central station service.'" In other words, it was urged that to permit the electric cooperative to acquire the power company through the acquisition of its securities would enable the electric cooperative to do indirectly what it could not do directly, and would negative the restrictions in the

statute under which the electric cooperative was formed. The Supreme Court of New Hampshire denied the validity of the arguments made and in doing so said:

> "We therefore find no basis in the statute for drawing the conclusion that although the Legislature expressly authorized electric cooperatives to own the securities of 'any corporation engaged in any related activity,' it intended that the securities of a public utility should be excepted. In consequence, we think that no occasion is presented to disregard the corporate entity of the Power Company in order to hold that the Cooperative proposes to serve persons which the statute does not permit it to serve. Cf. Higgins v. Smith, 308 U.S. 473, 477, 60 S. Ct. 355, 84 L. Ed. 406. What is denied by the statute is the right to serve substantial numbers of nonmembers without the restrictions of public regulation. This right will not be gained by acquisition of the Power Company securities. If it may be said that in reality the Cooperative will be serving Power Company customers, yet it will not be permitted to do so without regulation. If in a sense it will be doing indirectly what it is forbidden to do directly, it is sufficient to say that the doing by indirection is not prohibited, but permitted subject to regulation. See U.S. v. Cumberland Pub. Serv. Co., 338 U.S. 846, 70 S. Ct. 280; Berkey v. Third Ave. R. Co., 244 N.Y. 84, 155 N.E. 58, 50 A.L.R. 599." (Underscoring added.)

As pointed out in the foregoing quotations, the Supreme Court of New Hampshire held that the rates of the White Mountain Power Company would continue to be subject to regulation by the Public Service Commission of the State of New Hampshire, although the electric cooperative was by the terms of the statute under which it was incorporated entirely exempt from regulation by that Commission.

It was also urged that to permit the electric cooperative to acquire the White Mountain Power Company through the purchase of its securities would "violate the 'underlying basic policies of non-profit, cooperative enterprise.'" In this connection, the Court said:

> "Ownership of the securities will presumably be accompanied by the receipt of interest and dividends by the owner. This, it is suggested would violate the provision of R.L.c. 273, § 1, V that 'Associations organized hereunder shall be deemed non-profit; and it is said that the members of the cooperative would 'assume the role of investing stockholders in a non-member enterprise and (the cooperative) would become a commercial organization engaged in business "for profit to itself at the expense of a consuming public which would have no voice in the management of its affairs." Inland Empire Rural Electrification v. Dept. Pub. Service, [199 Wash. 527, 539, 92 P. 2d 258].'

"In general it may be recognized that the character of a cooperative is commonly considered to be that described in Inland Empire Rural Electrification v. Dept. of Pub. Serv., 199 Wash. 527, 539, 540, 92 P. 2d 258, 263, quoted by the State: '(I)t functions entirely on a cooperative basis * * * through which the users of a particular service * * * operate the facilities which they themselves own. The service, which is supplied only to members, is at cost, since surplus receipts are returned ratably according to the amount of each member's consumption.' While the by-laws of the New Hampshire Electric Cooperative are not before us, it does not appear to be disputed that its present operations conform in general to the procedures described in the quoted case. It appears that upon consummation of the proposed transfer, the income from the Power Company securities will be applied to repayment of the borrower purchase price. Presumably, upon satisfaction of this indebtedness, the income will become available for other uses by the cooperative, or for distribution to its members, either by reduction of the cost of service supplied, or by some other means. The question is whether this will be so far ultra vires of the Cooperative as to make ownership illegal. The precise meaning of section 1, V, is nowhere defined in the act. Similar provisions have been criticized as 'ambiguous, if not meaningless.' Evans & Stodyk, The Law of Cooperative Marketing, 237. The proposed investment and any resulting income will do no violence to the 'theoretical concept of a cooperative as an association serving only members, and "non-profit" (in the sense that all profit goes to its members rather than investors).' Schneider, Cooperatively Owned Utilities, 1939 Wis. Law Rev. 409, 410. See Manchester Dairy System, Inc. v. Hayward, 82 N.H. 193, 194, 199, 132 A. 12. We are not directly concerned with the question of whether such income will be subject to income tax, as plainly it may be. See Penn Mutual Life Ins. Co. v. Lederer, 252 U.S. 523, 534, 40 S. Ct. 397, 64 L. Ed. 698. Cf. Packel, The Law of Cooperatives, 2d Ed., § 62 (c) at 249. But even profits may be distributed upon a non-profit basis. See Farmer's Union Coop. Co. v. Com'r of Int. Rev., 8 Cir., 90 F. 2d 488; San Joaquin Valley Poultry Producers' Ass'n v. Com'r of Int. Rev., 9 Cir., 136 F. 2d 382. And in a sense, a saving of expense is a profit. State ex rel. Tray v. Lumbermen's Clinic, 186 Wash. 384, 394, 58 P. 2d 812. Cf. R.L.c. 334. What distinguishes the cooperative, among other things, is the absence of 'capital profit,' and the fact that 'capital investment receives no return or a limited return' which passes 'to the associates on a substantially equal basis or on the basis of their patronage of the association.' Packel, supra, 3, 4. See also Peer, Cooperatives and Proprietary Corporations, 34 Cornell Law Rev. 416, 417." (Underscoring added.)

The statute under which the electric cooperative was incorporated did not define what was meant by nonprofit. That statute did provide that "Associations organized hereunder shall be deemed non-profit," but this is not a definition. It is submitted that a fair interpretation thereof

would mean that an association organized in pursuance of the statute and which functioned in a manner and form permitted by the statute would insofar as that statute is concerned be regarded as nonprofit. The statute under which the electric cooperative was incorporated permitted such an association to own securities of other companies on which presumably interest or dividends would be paid, and the statute provides that an association that is authorized to do this shall be deemed to be a nonprofit association. In other words, the association appears to have been a nonprofit association only for the purpose of the particular statute in question.

There was a vigorous dissent from the majority holding, and in the dissent it was pointed out that the "Cooperative could not legally purchase outright the physical assets of the White Mountain Power Company and serve the customers of that concern." The dissenting opinion further stated that the opinion of the majority "allows the Cooperative to own and control all these same physical assets and serve all the same customers by ownership of all the stock of the Power Company. <u>If this is sound doctrine there is no legal obstacle to this non-profit Cooperative owning and controlling all the electric power utilities in the state</u>. I do not believe the Legislature intended this." (Underscoring added.)

MILK ANTITRUST CASE

On March 8, 1948, the Maryland & Virginia Milk Producers Association, Inc., its secretary-treasurer, and seven milk distributors operating in the Washington, D. C., area were indicted, charged with violating the anti-trust laws. (See Summary No. 38, page 10.)

On April 27, 1948, the District Court of the United States for the District of Columbia sustained a demurrer to the indictment and dismissed the case. The Government then attempted to carry the case directly to the Supreme Court of the United States, but in United States v. Maryland & Virginia Milk Producers Association, Inc., et al., 335 U.S. 802, the Supreme Court directed that the case be heard by the United States Circuit Court of Appeals for the District of Columbia before it would pass upon the merits.

On June 17, 1949, the United States Circuit Court of Appeals for the District of Columbia (See Summary No. 43, page 6), one Judge dissenting, reversed the District Court of the United States for the District of Columbia; and the Supreme Court of the United States then refused to grant certiorari, 70 S. Ct. 72.

In May 1950, the case came up for trial in the District Court of the United States for the District of Columbia. At the close of the Government's case, the defendants moved for a judgment of acquittal. The case was then dismissed as to three of the distributor defendants, apparently upon the ground that they did not have full-supply contracts with the association. Later the case was dismissed as to two of the distributor defendants on the ground that they were not engaged in interstate commerce.

On May 16, 1950, the Court found the Maryland & Virginia Milk Producers Association, its secretary-treasurer, and two of the milk distributors guilty of violating the antitrust laws. This conclusion appears to have been based upon the fact that the association had full-supply contracts with these distributors, embodying the use-classification plan of selling milk. Each of the distributors was fined $100, and the association $500; while its secretary-treasurer was fined $100, which was suspended.

It is understood that the Court regarded as applicable the case of Standard Oil Company of California v. United States, 69 S. Ct. 1051, Summary No. 43, page 1, in which the Standard Oil Company of California was found guilty of violating section 3 of the Clayton Act because it had entered into full-supply contracts with retail distributors of gasoline. The Supreme Court of the United States in the Standard Oil Company case specifically declined to pass upon the question of whether the full-supply contracts of that company violated the Sherman Act, although the Trial Court had found that such contracts violated the Sherman Act and the Clayton Act.

It is interesting to note that in the case under discussion, no violation of the Clayton Act was alleged in the indictment, but only that the defendants had violated the Sherman Act. It is understood that the association and the other defendants found guilty plan on appealing the case.

In passing upon the motion of the defendants for a judgment of acquittal, Judge Holtzoff handed down an opinion. In this opinion, after quoting section 6 of the Clayton Act and certain parts of the Capper-Volstead Act, he said:

> "Consequently, the Maryland and Virginia Milk Producers' Association, in marketing the milk shipped by its members and acting as their agent for that purpose, does not violate the Sherman Antitrust Act, even if in so doing it fixes prices and restrains trade. Its impunity ends, however, at the point where it commences to act in concert with others. Its exemption ceases when it crosses the line of individual action and combines with other persons who are not farmers. The Court of Appeals so held in this case and its ruling is the law of the case.
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> "The Supreme Court also reached the same conclusion in United States v. Borden Company, 308 U.S. 188.
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> "The conclusion necessarily follows that the Producers' Association may not be found guilty unless it conspired with the distributors and the resulting conspiracy was in violation of the Sherman Act. The activities of the Association, standing alone, may not be deemed a violation of the statute.
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> "The evidence introduced by the government tends to show that the Board of Directors of the Producers' Association from time to time fixed the prices to be charged to the distributors. Whenever the price was changed defendant Derrick, as Secretary-Treasurer of the Association, called a meeting of the distributors or their representatives. At this gathering he announced the new price. Occasionally some of the distributors protested or asked for a reduction, but to no avail. In other words, the price was not fixed as a result of negotiations or discussions between representatives of the association and the distributors. It was determined by the association and imposed on the distributors. The fact that the announcement was made in a meeting at which all distributors were present, instead of to each distributor separately, does not constitute a violation of the law. A conviction of a crime may not be predicated on such a hair-splitting refinement or fine-spun distinction.
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> "The conclusion is inescapable that there is no substantial evidence to sustain a finding that the Producers' Association combined with all the defendant distributors to fix the prices that the latter were to pay to the Association." (Underscoring added.)

One of the issues before the Court was the question of whether the association was a party to a conspiracy to fix the price of milk to consumers. In holding that there was no evidence that the association was a party to any such conspiracy, the Court said:

"We now pass to the third aspect of the alleged conspiracy, namely, the fixing of prices to consumers. There is no evidence whatever that the Producers' Association participated in any manner in determining prices to be charged to the consumers, except that on one occasion when a competitor of one of the defendant distributors reduced his retail prices, the Association temporarily committed itself to a price that would enable that distributor to withstand the competition. This activity is hardly a participation in a conspiracy to fix prices.

"The government offered in evidence lists of prices charged by the defendant distributors to their consumers. The government contends that the prices were changed by all of them on the same day and by the same amount, and seeks to draw on inference that this was done in concert. This contention is untenable, for two reasons.

"First, the compilation of the list shows that, as a matter of fact, prices were not always changed by all the distributors on the same day or by the same amount. Secondly, as was recently held by the Court of Appeals for the 8th Circuit in Pevely Dairy Company v. United States, 178 Federal (2d) 363, at 369:

> "'We are clear that mere uniformity of prices in the sale of a standardized commodity such as milk is not in itself evidence of a violation of the Sherman Antitrust Act.'" (Underscoring added.)

In holding that the full-supply contracts in conjunction with the classification or use plan of selling milk constituted a violation of the Sherman Act, the Court said in part:

> "The Court is of the opinion that 'full supply' contracts which embodied the classification plan for arriving at the price of milk constituted, in effect, agreements to fix prices. It is well settled that an agreement to fix prices of a commodity is per se an unreasonable restraint of trade, and, therefore, a violation of the Sherman Act. This principle was laid down in two leading cases decided by the Supreme Court: United States v. Trenton Potteries, 273 U.S. 392, at 397 et seq., and United States v. Socony-Vacuum Oil Company, 310 U.S. 150, at pages 212 et seq.
>
> "The conclusion is inescapable that there is substantial evidence justifying a finding that the operation of the 'full supply' contracts embodying the classification plan constituted a scheme for controlling and fixing prices of milk sold by the Association to the distributors, and, therefore, is an illegal restraint of trade in contravention of Section 3 of the Sherman Act."